Interest Rate Report:

Written: 4-12-2024 by Capital Flows Research:
https://www.capitalflowsresearch.com/

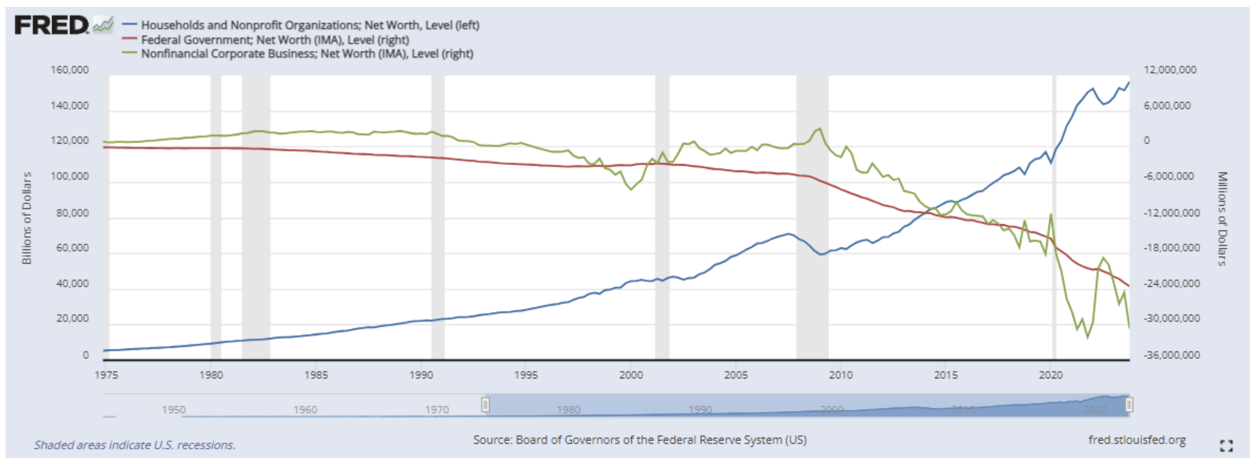
Introduction:

Since COVID-19, the global system has entered a structural regime characterized by higher nominal growth. While real growth remains considerably below nominal growth, it also remains resilient which creates the preconditions for inflation to NOT return to the inflation targets set by central banks. As a result of this dynamic, the inflation risks in the United States remain higher than in the past 40 years which is constraining both the market and central bank to deviate from past monetary cycle patterns and to operate within the cyclical tensions that exist. Structural tensions create the preconditions for cyclical impulses and cyclical impulses directly connect with the implied expectations in the risk premias of financial assets. This report will explain how the structural macro conditions in the United States set the preconditions for cyclical macro impulses and then further show how the most recent economic data and future implied probabilities of interest rates set the stage for the remainder of 2024.

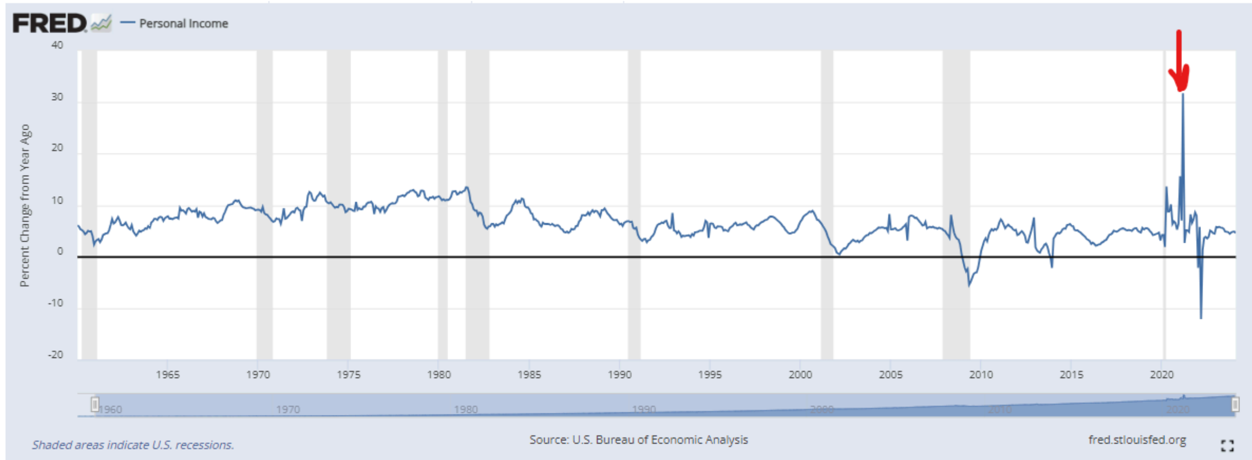
Structural Macro Regime:

The structural macro regime continues to be characterized by strength in the US consumer, cyclical sector resilience to rate hikes, and an increase in government spending. The collocation of these three dynamics is causing nominal demand to exceed real output which results in inflation.

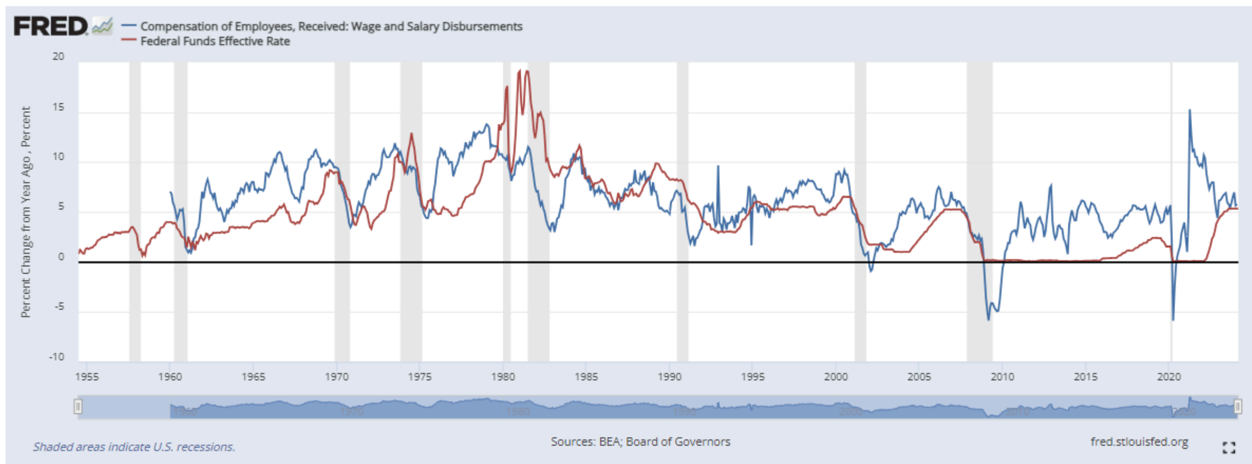
The US consumer continues to have a positive net wroth in comparison to corporations and the government. The implication of this is that their liabilities are significantly less than the US government or corporations.



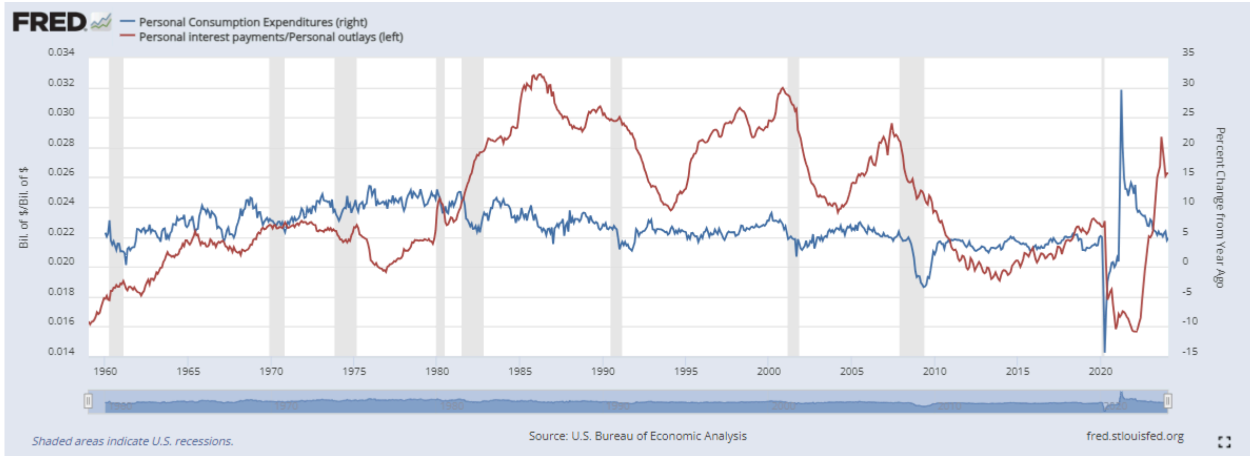
The fiscal transfers during 2020 changed the typical transmission mechanism that exists between financial markets and the economy. As a result, there has been a steep up in the basis of the amount of money in the system. While many market participants are focusing on the monetary lag of the Fed's hiking, it is still unclear if the strength of this impulse in personal income has made its way through the entire system.



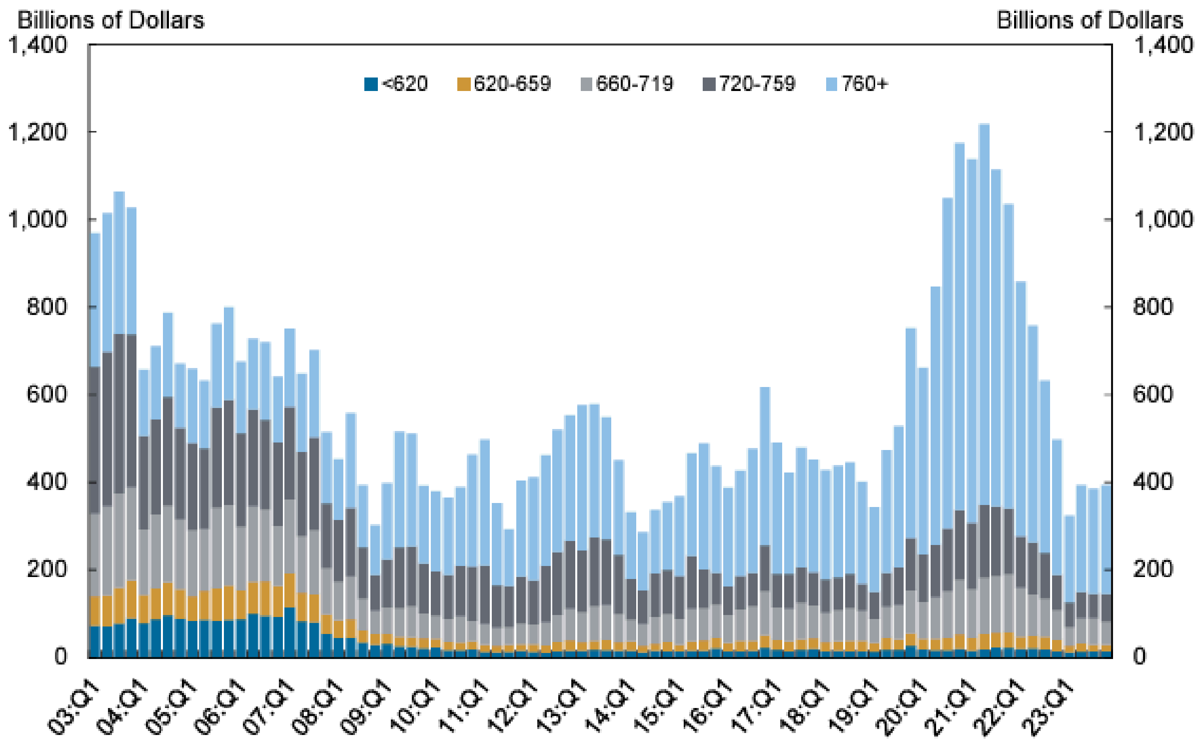
Wages remain ABOVE the Fed Funds rate:



And the rise in debt service payments as a % of personal outlays isn't dragging down personal consumption enough in order to cause headline GDP numbers to turn negative:

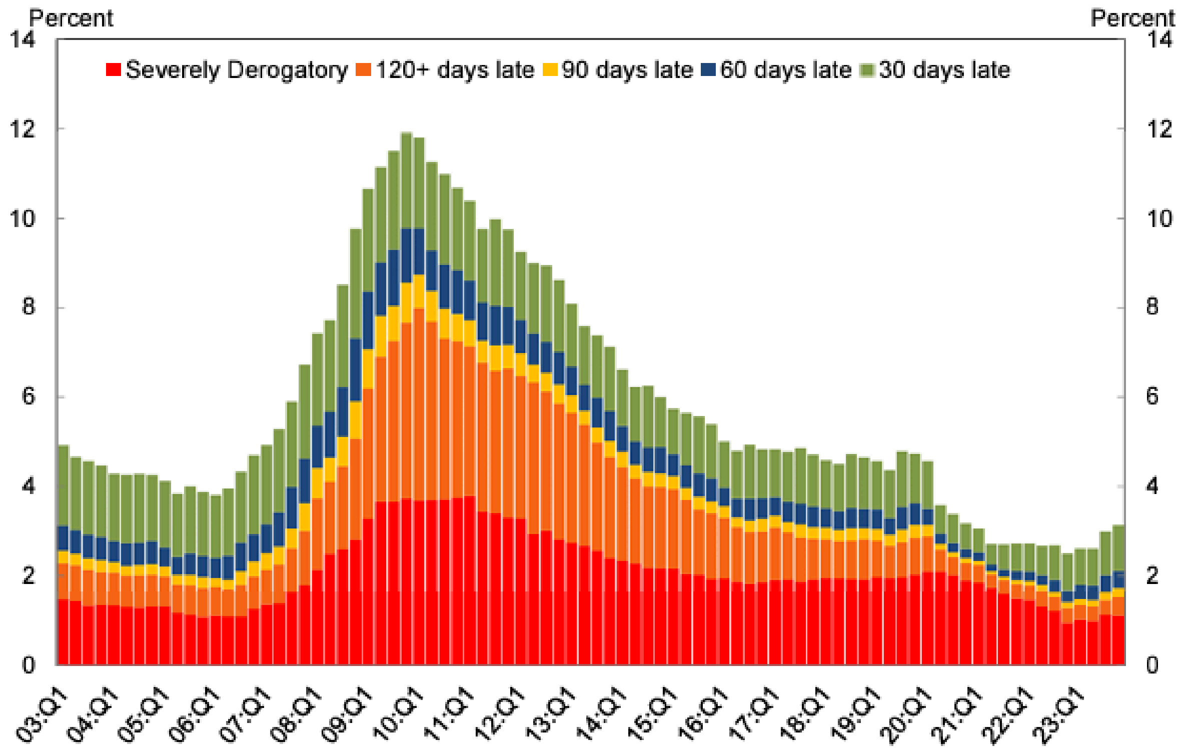


The strength in the US consumer is also due to the quality of total mortgage originations by credit score:



This quality of the US consumer coupled with a low number of adjustable rate mortgages is suppressing total delinquencies:

Total Balance by Delinquency Status



Source: New York Fed Consumer Credit Panel/Equifax

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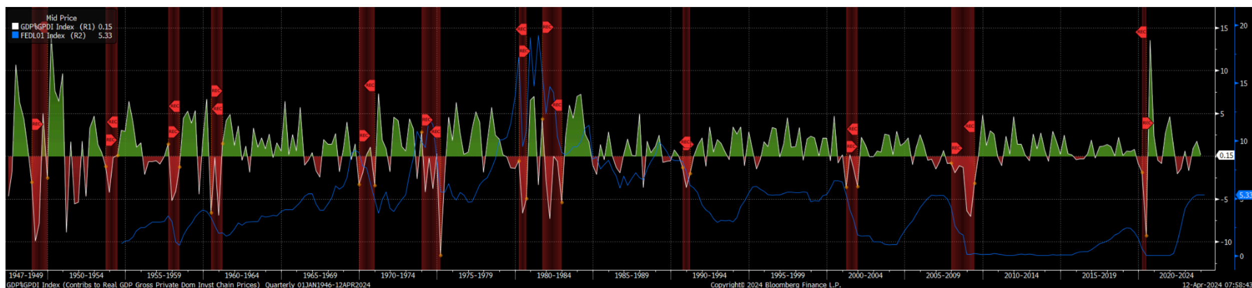
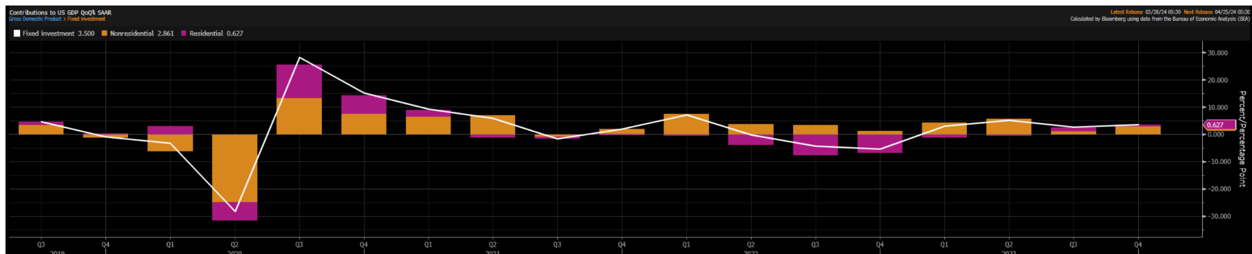
The quality of the US consumer is directly connected to the cyclical resilience we are seeing in the investment portions of GDP. Fundamentally, cyclically sensitive sectors typically see some degree of contraction during hiking cycles due to their capital-intensive nature. However, the investment portions of GDP continue to show broad resilience to the rate hikes that have taken place. This resilience in investment is due to the strength in the housing market and domestic investment due to onshoring.

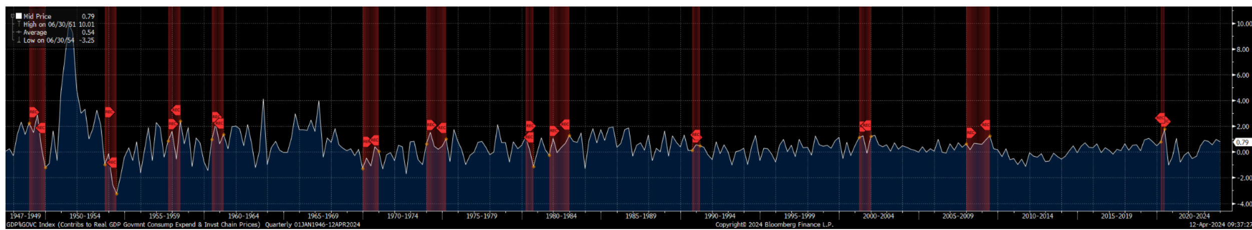
Chart: Real domestic investment as a contribution to headline GDP and Fed Funds. We can see that real investment remains positive in spite of the rate hikes:



On QoQ basis the investment line item of GDP remains positive:



The final structural dynamic to note is the contribution of government spending to nominal GDP. Typically government spending is countercyclical to provide support to headline GDP as other line items are in contraction. We are currently experiencing procyclical government spending that is putting additional upward pressure on nominal growth. The chart below is real government spending's contribution to GDP change:

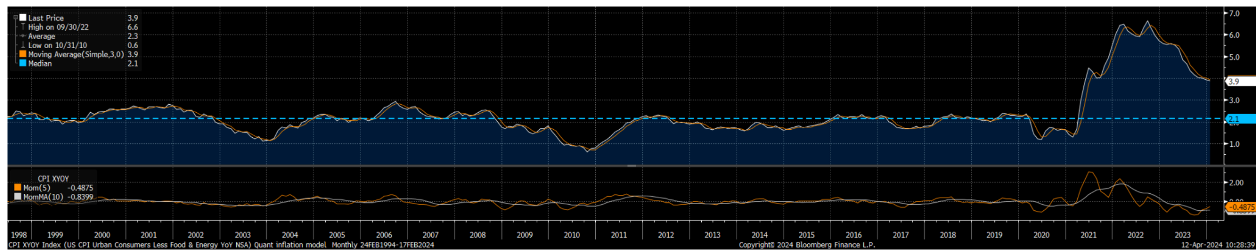


Bottom line: We are seeing the collocation of all the major line items in GDP accelerate and reflect resilience to the recent rate hikes. This combined resilience creates marginal reflexivity between the underlying components where line items help fuel positive attribution to each other. The result of this dynamic is elevated nominal growth.

Cyclical Impulse:

The structural macro regime creates the preconditions for cyclical impulses as they are dynamically realized in the economic data releases. We are currently in a regime characterized by positive growth and positive liquidity (the quantity of money continues to expand). Inflation in the macro regime has very specific tensions given its LEVEL and RoC (rate of change) as it relates to the Fed's 2% target. We remain at an elevated level and the risk of inflation reaccelerating on a YoY basis has increased due to the last CPI print.

Core CPI remains 200bps above the Fed's target and accelerated on a YoY basis on the last print:

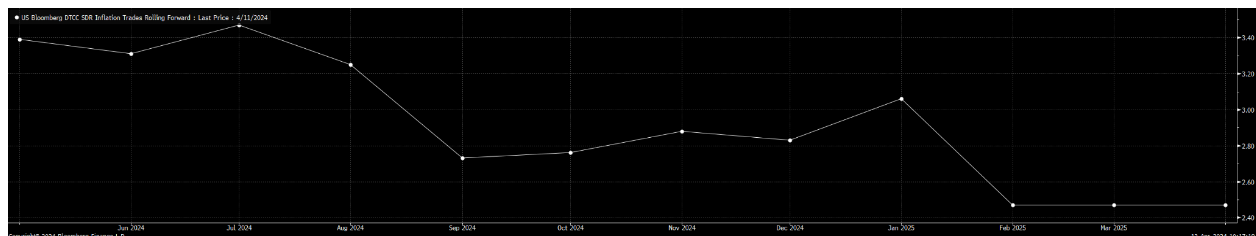


This marginal YoY reacceleration from 3.762% to 3.797% has outsized significance for the forward path of inflation given the preconditions in growth noted above and the fact that we remain at an elevated level. If the speed of the most recent reacceleration continued, this would be the forward path (this is a projection):

Scenario 1: Using the Most Recent Basis Point Change (+4 basis points monthly)

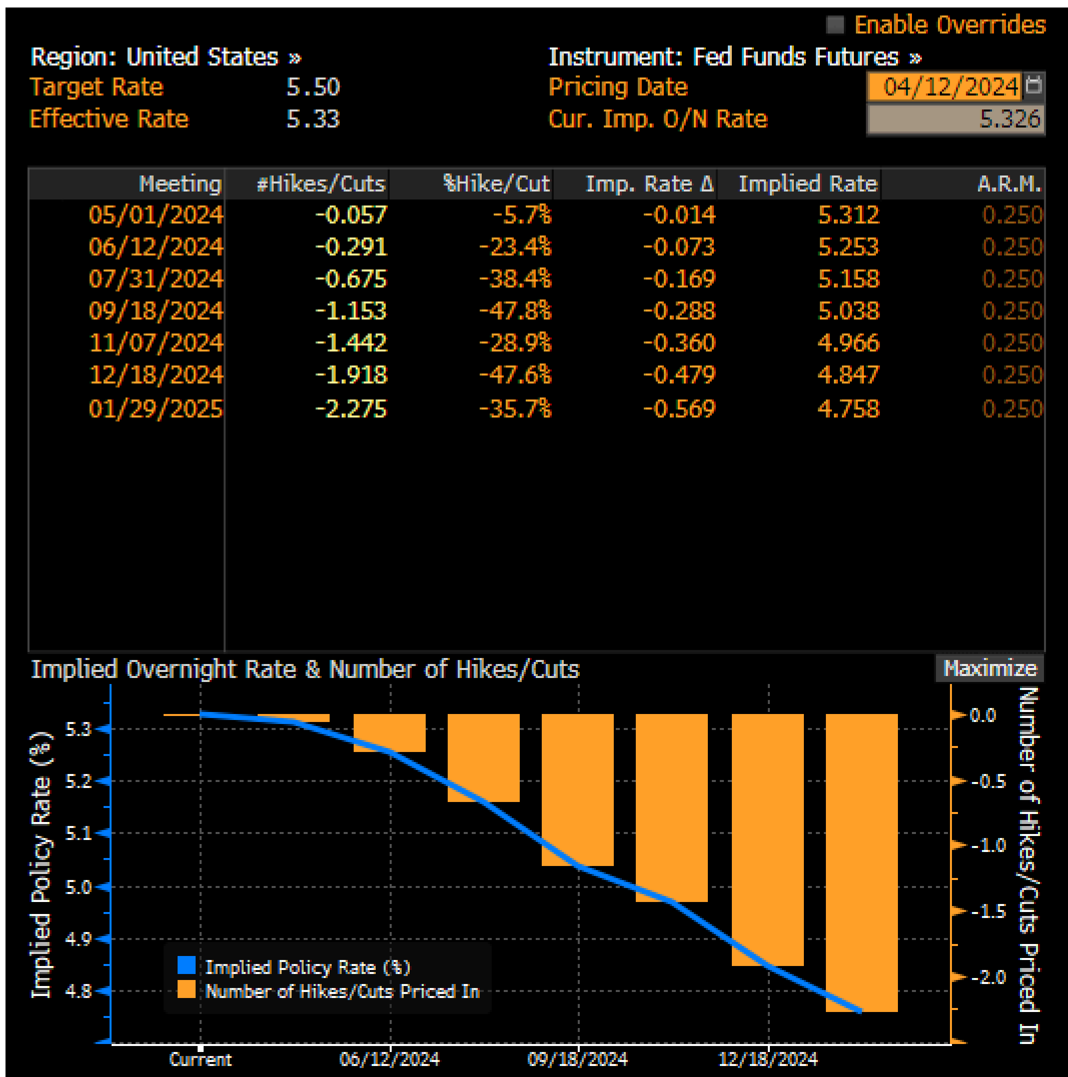
Month	Extrapolated YoY Inflation Rate (%)
2024-04-01	3.84
2024-05-01	3.88
2024-06-01	3.92
2024-07-01	3.96
2024-08-01	4.00
2024-09-01	4.04
2024-10-01	4.08
2024-11-01	4.12
2024-12-01	4.16
2025-01-01	4.20
2025-02-01	4.24
2025-03-01	4.28

This projected path in core CPI is not being priced in by inflation swaps right now:



While 2-year inflation swaps have been rallying, there is still upside if a persistent reacceleration in inflation takes place.

The primary thing the market is trying to price is what the forward path for inflation will be. This is why the market has repriced the number of rate hikes due to the marginal change in inflation. The marginal change in core inflation has drastic implications for the forward path:



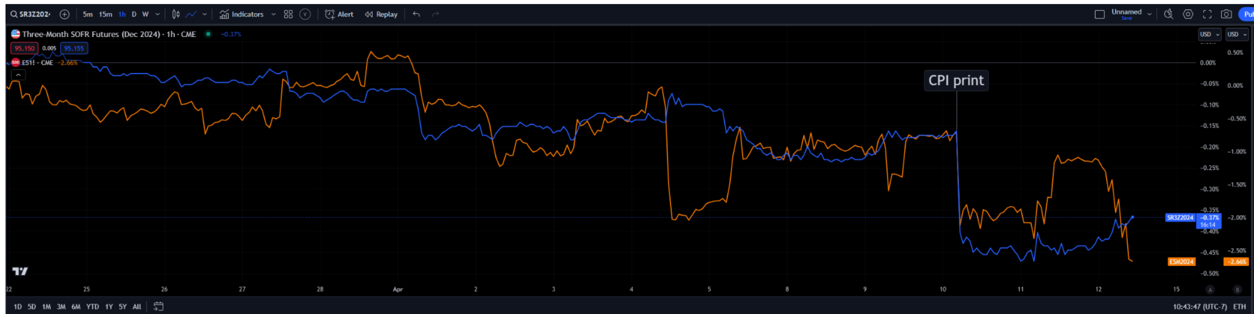
Enable Overrides

Region: United States »
Target Rate 5.50
Effective Rate 5.33

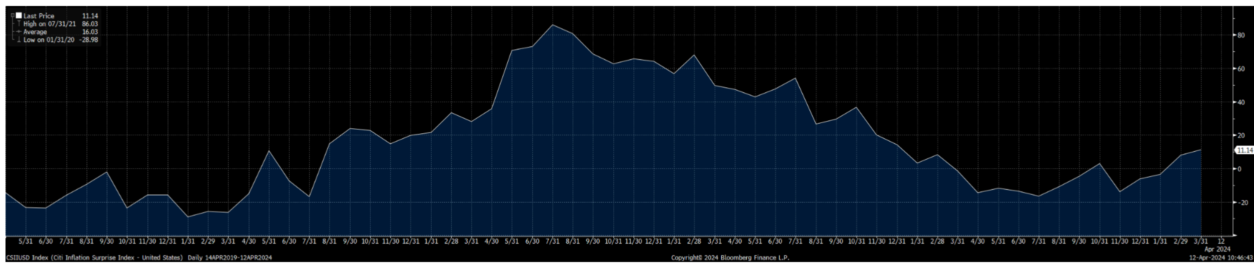
Instrument: Fed Funds Futures »
Pricing Date 04/12/2024
Cur. Imp. O/N Rate 5.326

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
05/01/2024	-0.057	-5.7%	-0.014	5.312	0.250
06/12/2024	-0.291	-23.4%	-0.073	5.253	0.250
07/31/2024	-0.675	-38.4%	-0.169	5.158	0.250
09/18/2024	-1.153	-47.8%	-0.288	5.038	0.250
11/07/2024	-1.442	-28.9%	-0.360	4.966	0.250
12/18/2024	-1.918	-47.6%	-0.479	4.847	0.250
01/29/2025	-2.275	-35.7%	-0.569	4.758	0.250

The repricing of cuts in the the December SOFR contract has had direct implications on equities due to how much of their realized returns YTD were due to valuation expansion:

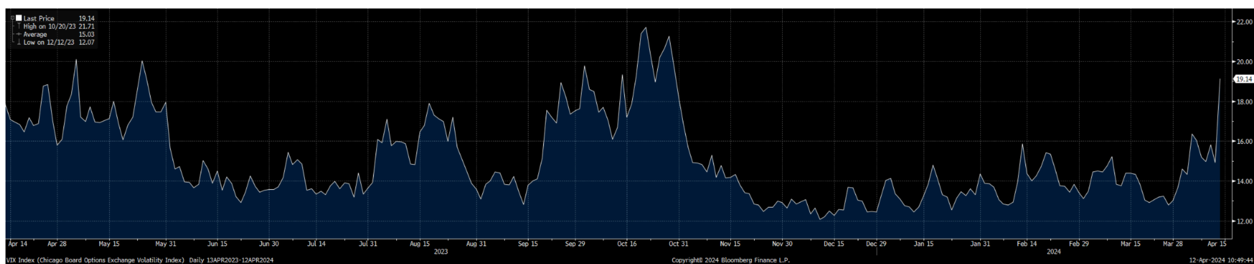


As a result of inflation surprising expectations and a repricing of the forward curve, we are likely to see a marginal shift in positioning as traders readjust their exposure: Inflation surprise index



This surprise to expectations and the following implications for positioning is the reason cross-asset implied vol has spiked. FX vol has accelerated from its lows:

The VIX is rising:



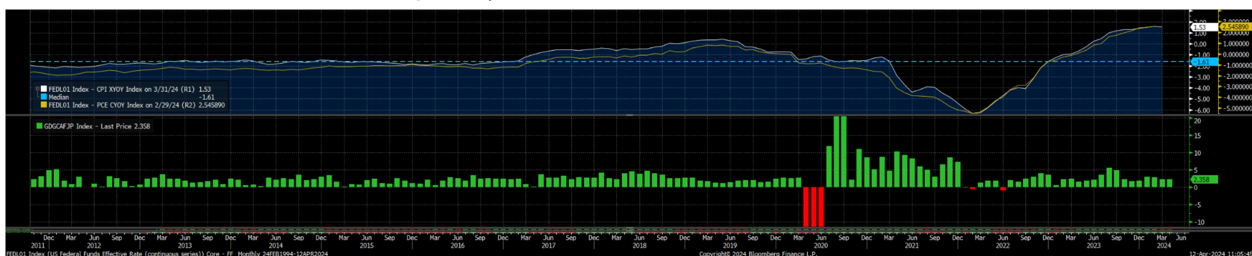
The MOVE Index is rising:

And FX carry trades (FX carry trade index in white) are unwinding marginally as we have a strong dollar combined with a rise in the VIX (blue):

This impulse in markets and its impact on positioning must be directly compared with proper scenario analysis in order to correctly determine the distribution of probabilities for assets and potential opportunities for generating alpha.

Scenario Analysis:

- **Scenario 1:** YoY core inflation reaccelerates above 4% by December 2024 resulting in all of the cuts on the forward curve being repriced and the Fed refraining from any cuts or hikes. Given the strength in growth, the Fed is continuing to target a spread between Fed Funds and inflation (top panel of chart) dependent on growth (Atlanta Fed GDP-nowcast in bottom panel) and financial conditions.



    - In scenario 1, if growth remains strong and financial conditions remain loose, the Fed is likely to keep the Fed Funds rate - YoY Core CPI spread between 100-150bps.
- **Scenario 2:** YoY core inflation decelerates into the end of 2024 but at a significantly slower pace. In this scenario, we could still get the “insurance cuts” from the Fed to decrease the Fed Funds Rate from its cyclical extreme. However, it is likely 1-2 cuts at most as opposed to the high conviction the market was previously pricing for 3.

Scenario 2: Using the Average of the Last 3 Months' Basis Point Changes (-2.33 basis points monthly)

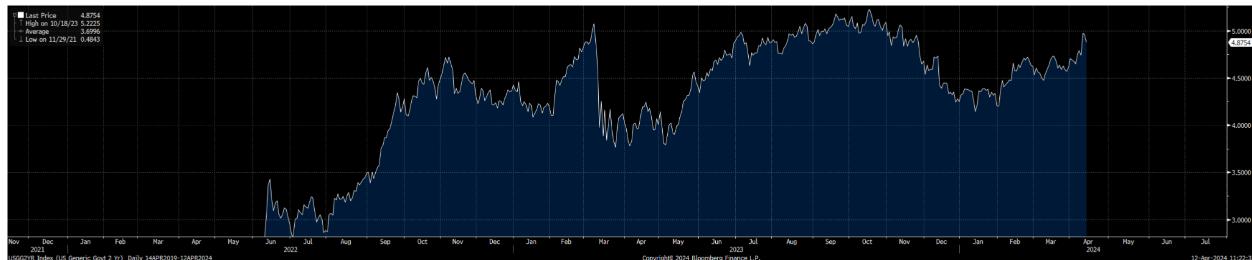
Month	Extrapolated YoY Inflation Rate (%)
2024-04-01	3.7777
2024-05-01	3.7544
2024-06-01	3.7311
2024-07-01	3.7078
2024-08-01	3.6845
2024-09-01	3.6612
2024-10-01	3.6379
2024-11-01	3.6146
2024-12-01	3.5913
2025-01-01	3.5680
2025-02-01	3.5447
2025-03-01	3.5214

- In scenario 2, if inflation decelerated 100bps to 3.5% then this would give the Fed a little more room in the Fed Funds - YoY Core inflation spread to have 1-2 insurance cuts depending on how growth data is released between now and then.

These scenarios are the two primary outcomes that are most likely given the current information available. Within these scenarios, the market is pricing implied futures for rates and equities.

Rates:

Short-end rates are back at the 5% resistance level pricing a marginal probability of cuts over the next 2 years. While the most recent move has shaken positioning, it is still going to be incredibly difficult for a durable break to all-time highs in the 2-year. While inflationary pressures remain in the system, there is a significant discontinuity in the strength of the impulses we experienced in 2021 and 2022. The 2-year is in a mean reversion range on a longer-term basis.



Long-end rates have significantly more risk moving into the end of the year due to the recent developments in the inflation picture. Since the yield curve remains inverted, it is difficult for institutions to move out the duration risk curve.

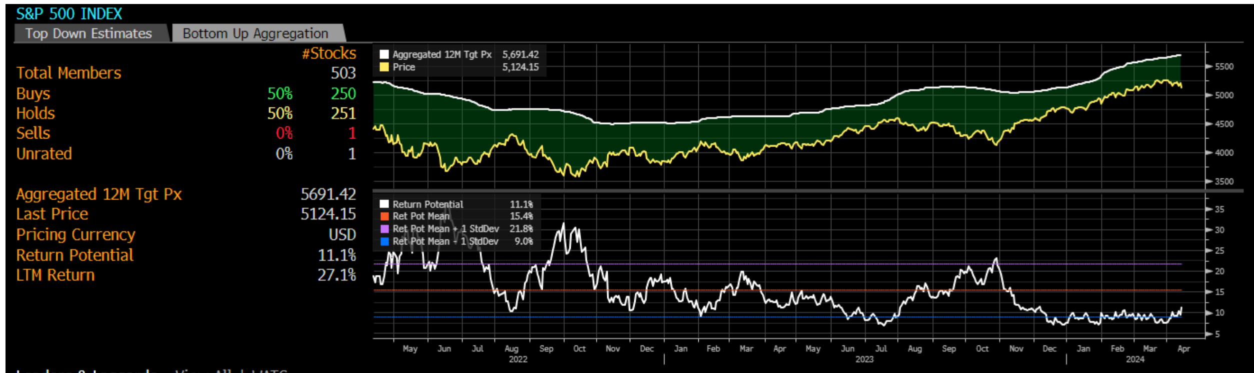
The tension that exists is that the yield curve remains inverted and the short end is going to experience additional pressure if YoY inflation accelerates. As a result, a steepening in the curve is likely to take place due to long-end rates moving up as opposed to short-end rates moving down.

SOFR curves continue to steepen but 2s10s is diverging marginally:

This situation implies being long duration has an incredibly low risk reward here. Taking the other side of unrealistic extremes in the STIR contracts continues to provide opportunity and being long the steepener still has upside due to the pricing of long end rates.

Equities:

While growth expectations and their underlying cash flows don't currently have significant risks, a bear steepener could cause a marginal drag on equities similar to 2023. The deviation in price from analysts' expectations creates higher sensitivity to the valuation function which has higher sensitivity to a potential bear steepener:



A marginal pullback to 5,000 in SPX is possible until this reacceleration risk in inflation decreases.

Px = 5122.03 (Actual) @ P/E of 24.6x
Px = 6298.06 @ P/E of 30.3x
Px = 5487.1 @ P/E of 26.4x
Px = 4676.14 @ P/E of 22.5x
Px = 3865.18 @ P/E of 18.6x
Px = 3054.22 @ P/E of 14.7x
6000
5000
4000
3000
2000
2019 2020 2021 2022 2023 2024
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Conclusion:

The primary tension to keep in mind is that the current impulse in markets post CPI is likely to have significant discontinuity from the moves we saw in 2022 and 2023 (with the bear steepener). This impulse is likely to be much shorter in duration than the bear steepener in 2023 that created a drag on equities. At the first sign of any declaration of inflation, these flows are likely to have a violent reversal. In the interim, views should be taken in confluence with the scenario analysis laid out above.

All the research can be found at: https://www.capitalflowsresearch.com/